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No. 01-1209

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IN THE

Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the the United States Court of Appeals for the Ninth Circuit

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the Petition for a Writ of Certiorari filed by Boeing Company and its subsidiaries.[1] Tax Executives Institute ("TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business

[1] Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, its members' companies, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioners and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and has approximately 5,300 members who represent more than 2,700 of the leading businesses in the United States, Canada, and Europe. The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws and to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers.

Members of the Institute have a vital interest in this case, which involves the resolution of a sharp conflict concerning the interpretation of tax statutes affecting the foreign commerce of the United States. The substantive issue in the case is whether Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of research and development expenses) should override the intended operation of the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code. Eight years ago, the U.S. Court of Appeals for the Eighth Circuit held in *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394 (1994), that the Treasury Regulation is invalid in this context, noting that the mandated allocation method is inconsistent with Congress's intent to allocate costs to definitely related gross receipts. In the instant case, the U.S. Court of Appeals for the Ninth Circuit declined to follow *St. Jude Medical* and held instead that the regulation is valid.

By creating a split in the circuits, the Ninth Circuit's decision robs taxpayers of needed certainty about the proper allocation of research and development costs relating to income taxed under the DISC, FSC, and related provisions of the Internal Revenue Code. The unsettling effect of the Ninth Circuit's opinion on the tax system as a whole is a material concern to the Institute and its members. It is not unusual for large multinational companies such as Boeing to have many

years under examination by the Internal Revenue Service. The Ninth Circuit's decision will undoubtedly increase the number of disputes between taxpayers and the IRS. As individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

For more than three decades, the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code have provided much needed tax relief for U.S. companies competing in foreign markets. The issue presented here involves the validity of a Treasury Regulation that improperly allocates research and development expenses to income under both the DISC and FSC provisions.

1. This case presents an ongoing question of significant importance on which the courts of appeals are in sharp conflict. The issue was previously decided in favor of the taxpayer in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994). Here, the Ninth Circuit found for the government, frankly admitting that it "decline[d] to follow the reasoning of *St. Jude Medical*."

The Ninth Circuit's opinion strips away the relative certainty taxpayers and the government had under *St. Jude Medical*—imposing significant administrative barriers to the resolution of this issue by taxpayers and the government. In the absence of a resolution, protracted litigation may be the only solution for large taxpayers that may have many years still open under the applicable statute of limitations.

Amicus TEI submits that this Court should resolve the conflict to preserve the uniform application of the tax law and to avoid disparate treatment of similarly situated taxpayers based solely upon their geographical location.

2. The resolution of the question presented in this case affects many companies and tax years, past, present, and future.

The IRS has reported that during 1992-1996 (the years for which the most recent data are available), the total income, cost of goods sold, foreign trade deductions, and net exempt income for FSCs all doubled, indicating an overall increase in the size of the average FSC. During the same period, there was a 42-percent increase in the number of FSC returns filed, and assets in these corporations rose almost 50 percent. Cynthia Belmonte, *Foreign Sales Corporations, 1996*, 19 STAT. OF INCOME BULL. No. 4, 87, 94 (Spring 2000). Estimates for the FSC replacement regime also demonstrate the importance of this issue: nearly $4.5 billion over a 10-year period. Staff of the Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4986, FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, JCX-98-00 (Sept. 15, 2000). But perhaps the best way to confirm the national importance of the DISC and FSC provisions is to recognize that over three decades—whenever the regimes were threatened—Congress has always acted swiftly and consistently to enact replacement legislation.

In view of the substantial national importance of the DISC and FSC regimes, review by this Court is warranted.

3. The substantive tax issue in this case involves the allocation of Boeing's R&D expenses to the income generated by its export sales of commercial aircraft under the DISC and FSC provisions of the Code. The Ninth Circuit concluded that in computing the company's net income, the Commissioner "properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales." The court's conclusion is wrong as a matter of law.

The DISC provisions permit corporations to defer part of their income tax on sales, licenses, or leases of export property that is manufactured or produced in the United States and sold or leased through a DISC for use outside the country. Boeing

used the combined taxable income (CTI) method for calculating its intercompany revenues. Under Treas. Reg. § 1.994-1(c)(7), the pricing of goods sold by a taxpayer to its DISC is made on a transaction-by-transaction basis, but the taxpayer may annually elect to group the transactions according to product lines. The taxpayer's choice of groupings is controlling under the regulation. Before calculating its CTI, the taxpayer must allocate its costs—including R&D costs—between foreign and domestic sales. These costs are defined in Treas. Reg. § 1.994-1(c)(6)(iii) as "the expenses, losses, and other deductions *definitely related, and therefore allocated and apportioned, thereto,*" and a ratable part of any other expenses that are not definitely related to a class of gross income. The regulation references Treas. Reg. § 1.861-8, which allocates R&D expenditures according to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget.

Boeing grouped its export sales by program and apportioned costs, including R&D costs, to the particular airplane program for which those costs were incurred under Treas. Reg. § 1.994-1(c)(7). The IRS disagreed, maintaining that the allocation should be grouped according to SIC Code 37 for "Transportation Equipment," regardless of the relationship of the R&D expenses to the product being sold. Thus, the IRS's method reduced Boeing's CTI for a current program within a given year by the R&D expenses incurred for a different program that same year. The reallocation resulted in a tax deficiency of more than $400 million.

In upholding Boeing's CTI calculation, the district court turned to the Eighth Circuit's decision in *St. Jude Medical*, which held that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the CTI calculation. Finding the Eighth Circuit's reasoning and analysis "persuasive and applicable to the current case," the district court found that there were serious defects in applying Treas. Reg. § 1.861-8(e)(3) to the

computation of CTI that were "fatal" to the validity of the regulation. On appeal, the Ninth Circuit reversed, holding that Treas. Reg. § 1.861-8(e)(3) as applied to the CTI calculation is a permissible interpretation of the statute. The appellate court's reasoning is at odds with the DISC's statutory scheme and cannot be sustained.

The DISC statute clearly requires that there be a factual connection between income and expense. The legislative history confirms that expenses unrelated to property being exported are not allocated to export sales of the property. As the Ninth Circuit noted, a taxpayer is permitted to choose the pricing method that maximizes its DISC's profits. In spite of the regulation's clear language that a taxpayer's groupings "shall be controlling," the court found that Boeing *was required* under the regulations to use a broad two-digit SIC classification for allocating R&D expenses. As the Eighth Circuit determined in *St. Jude Medical*, however, "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." 34 F.3d at 1401 (citations omitted).

The DISC intercompany pricing rules are consistent with congressional intent because they permit taxpayers to choose their product groupings. Under the section 994 regulations, expenses directly related to a particular product group are not allocated to the sales from a different product group. Consistent with congressional intent, a DISC can therefore maximize the amount of its deferred tax on export income because its deductions are limited to directly related expenses and an allocated portion of unrelated expenses (such as overhead). This clearly accords with the statute.

The Ninth Circuit's decision forces taxpayers to allocate expenses that are directly related to a particular product—such as the Boeing 767—to income from unrelated products—such as the Boeing 747 which was designed years

before—because both the 747 and the 767 are in the same broad two-digit SIC Code. Even using a narrower three-digit SIC Code results in grouping such dissimilar products as floor wax and perfume or canned tuna and freeze-dried coffee. Such a ridiculous result cannot stand.

4. The Ninth Circuit's decision will undoubtedly increase the number of disputes between taxpayers and the IRS. As Justice Brandeis has noted, "it is more important that the applicable rule of law be settled than that it be settled right." *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). This case presents the opportunity for the Court to do both: to settle the issue and to get it right.

Boeing's Petition for a Writ of Certiorari should be granted.

ARGUMENT

I.

Over the past 30 years, Congress has enacted legislation that seeks to address the inequities that arise when U.S.-based companies compete in foreign markets because of the fundamental differences between the U.S. system of taxation and those of many other countries. The legislation provides a more level playing field for these companies. Two such regimes are under review in this case. In 1971, deficits in the United States' balance of trade led to the enactment of the domestic international sales corporation (DISC) provisions of the Internal Revenue Code. *See* Revenue Act of 1971, Pub. L. No. 92-178, 92nd Cong., 1st Sess. § 501; *L&F Int'l Sales Corp. v. United States*, 912 F.2d 377, 377 (9th Cir. 1990).[2] Following a

[2] A corporation qualifying as a DISC is not subject to current taxation. The DISC's parent corporation is taxed on a specified portion of the DISC income as a "deemed" distribution; the remaining income is tax-deferred until distributed to the parent or the corporation ceases to qualify as a DISC. The income is apportioned between the two entities according to one of three pricing methods. I.R.C. §§ 991-997. The pricing method used by Boeing here is the combined taxable income (CTI) method.

challenge under the General Agreement on Tariffs and Trade, Congress replaced the regime in 1984 with the foreign sales corporation (FSC) provisions. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98th Cong., 2d Sess., § 801(a).[3] Although there are technical differences between the two regimes, the FSC provisions retain many features in common with the predecessor DISC statute. For more than three decades, these provisions have served their purpose.

This case involves the proper allocation of research and development expenses to income under both the DISC and FSC provisions,[4] an issue of significant importance on which the courts of appeals are in sharp conflict. As the district court recognized, this was not an issue of first impression. App. at 18a.[5] The issue was previously decided in favor of the taxpayer in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994). Here, the Ninth Circuit made no attempt to distinguish that case, but frankly admitted that it "decline[d] to follow the reasoning of *St. Jude Medical*." App. at 10a.

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[3] A FSC is generally not subject to taxation on its "exempt foreign trade income," which is treated as foreign source income not effectively connected with the conduct of a U.S. trade or business. Again, the income is apportioned between the FSC and its parent according to one of three alternative pricing methods. I.R.C.§§ 921-927.

[4] Parts of the DISC provisions technically remain in effect after the enactment of the FSC provisions. I.R.C. § 995. In 2000, because of a trade dispute over the validity of the FSC regime, Congress repealed the FSC provisions and enacted the extraterritorial income (ETI) provisions. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000), *codified at* I.R.C. §§ 114, 941-943. All three regimes implicate the same questions concerning the grouping of transactions and the allocation of research and development expenses. *See, e.g.*, I.R.C. § 943(b)(1)(B) (grouping of transactions for ETI purposes). Thus, the issue presented in this case has ongoing significance.

[5] References to "App." are to the appendix filed with Boeing's Petition for a Writ of Certiorari to the U.S. Court of Appeals for the Ninth Circuit, No. 01-1209 (Feb. 15, 2002).

As an organization dedicated to minimizing the costs and burdens of tax administration, *amicus* TEI is deeply concerned about the disruptive effect of the conflicting opinions. The companies that employ TEI's members have almost without exception been assigned to the Large and Mid-Size Business (LMSB) Division of the Internal Revenue Service (IRS). The largest 1,600 taxpayers within LMSB are subject to continual audits as part of the IRS's Coordinated Industry Cases (CIC) program. It is not unusual for these taxpayers to have many years still open for audit under the statute of limitations. The Ninth Circuit's opinion deprives taxpayers of the certainty promised by the decision in *St. Jude Medical* and casts doubt on the proper method for allocating research and development expenses. This uncertainty erects significant administrative barriers to the resolution of this issue by taxpayers and the government. Protracted litigation seems inevitable. In short, the Ninth Circuit's opinion has frustrated the orderly and principled administration of the tax laws.

Amicus TEI submits that this Court should resolve the conflict to preserve the uniform application of the tax law and to avoid disparate treatment of similarly situated taxpayers based solely upon their geographical location. "Uniformity among the circuits is especially important in tax cases to ensure equal and certain administration of the tax system." *First Charter Fin. Corp. v. United States*, 669 F.2d 1342, 1345 (9th Cir. 1982). *Accord Nickell v Commissioner*, 831 F.2d 1265, 1270 (6th Cir. 1987). Thus, the split in the circuits warrants review by this Court.

II.

This case has significant ramifications for companies other than Boeing. The resolution of the question presented in this case affects the taxes owed by thousands of other businesses that are also subject to these provisions. A review of the cases involving the regimes over the past 25 years illustrates some of the significant U.S. companies using FSCs and

DISCs. *See, e.g., Dresser Indus., Inc. v. United States*, 238 F.3d 603 (5th Cir. 2001) (DISC and FSC provisions); *General Electric Co. v. Commissioner*, 245 F.3d 149 (2d Cir. 2001) (DISC); *Intel Corp. v. Commissioner*, 76 F.3d 976 (9th Cir. 1996) (FSC and DISC); *St. Jude Medical*, 34 F.3d at 1304 (DISC); *Microsoft Corp. v. Commissioner*, 115 T.C. 228 (2000), *appeal pending*, No. 01-71584 (9th Cir.) (FSC); *Union Carbide Corp. v. Commissioner*, 110 T.C. 375 (1998) (FSC); *General Dynamics Corp. v. Commissioner*, 108 T.C. 107 (1997) (DISC and FSC); *Caterpillar Tractor Co. v. United States*, 589 F.2d 1040 (Ct.Cl. 1978) (DISC); *Oracle (Barbados) Foreign Sales Corp. v. Commissioner*, Tax Ct. Dkt. Nos. 13298-98 through 13301-98 (FSC).

In addition, under transition rules provided by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, taxpayers will have to determine their tax liability under these rules for many years to come. Further, although complete guidance has yet to be issued, it is inevitable that the grouping rules will be used in the implementation of the new ETI regime, highlighting the need for certainty in calculating tax liabilities. Thus, this case affects many companies and tax years, both past and present.

IRS statistical reports also demonstrate the importance of the provisions to business taxpayers. During the four-year period from 1992-1996 (the most recent years for which data are available), the IRS reported that the total income, cost of goods sold, foreign trade deductions, and net exempt income for FSCs all doubled, indicating an overall increase in the size of the average FSC. Cynthia Belmonte, *Foreign Sales Corporations, 1996*, 19 STAT. OF INCOME BULL. No. 4, 87 (Spring 2000) (hereinafter cited as "SOI"). During the same period, there was a 42-percent increase in the number of FSC returns filed, and assets in these corporations rose 48 percent to more than $26 billion. Total gross receipts of the FSCs and their related suppliers reached $285.9 billion in 1996, up from $152.3 billion four years earlier. A total of $12.4 billion

in deductions was allocated to the $20.9 billion of FSC exempt income in 1996. *Id.* at 87, 94.[6] Indeed, the amount of money at issue in this one case alone ($419 million through 1987) demonstrates the importance of this case for corporate taxpayers. App. at 1a.

The point is underscored by the estimates prepared by the staff of the Joint Committee on Taxation in 2000. The Joint Committee staff estimated that the revenue effects of the ETI provisions were nearly $4.5 billion over a 10-year period. Staff of the Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4986, FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, JCX-98-00 (Sept. 15, 2000).[7]

But perhaps the best way to confirm the national importance of the DISC and FSC provisions is to consider the actions of Congress over three decades:

- Congress enacted the DISC provisions in 1971 to reduce the U.S. balance-of-payments deficits. H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 9, 58 (1971), *reprinted in* 1972-1 C.B. 498, 502, 529.
- When the DISC provisions were challenged under the General Agreement on Tariffs and Trade in the late 1970s, Congress enacted the FSC provisions as a replacement regime. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98th Cong., 2d Sess., § 801(a).
- When those provisions were challenged 14 years later in the dispute resolution process of the World Trade Organization, Congress once again passed replace-

[6] Transportation equipment—the category in which Boeing's receipts fall—accounted for $51.9 billion of gross receipts. SOI at 87.

[7] The United States recently estimated that the effect of the FCS/ETI benefits in respect of the European Union's challenge to those regimes in the WTO is $4.15 billion in 2000 and $3.91 billion in 2001. *See Extraterritorial Income: U.S. Says Up to $1.11 Billion in Sanctions May Be Justified for FCS/ETI Retaliation*, BNA DAILY TAX REP., No. 40, at G-6 (Feb. 28, 2002). The EU's share of total world production for 2000 was 26.8 percent. *Id.* at G-7.

ment legislation. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000).

Thus, Congress has consistently acted to ensure the competitiveness of U.S. companies. In view of the substantial national importance of the DISC and FSC regimes, review by this Court is warranted to resolve the important question presented in this case.

III.

The substantive tax issue in this case involves the allocation of Boeing's R&D expenses to the income generated by its export sales of commercial aircraft under the DISC and FSC provisions of the Internal Revenue Code. The Ninth Circuit concluded that in computing the company's net income, the Commissioner "properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales." App. at 2a. The court's conclusion is wrong as a matter of law.

Enacted to provide a more level playing field for U.S. companies competing in foreign markets, the DISC provisions permit corporations to defer part of their income tax on sales, licenses, or leases of "export property." That property must be manufactured or produced in the United States and sold or leased through a DISC for use outside the United States. In addition, not more than 50 percent of the property's fair market value may be attributed to products imported into the United States. I.R.C. § 993(c)(1). Intercompany pricing rules permit the taxpayer to elect one of three methods to determine the amount of revenue allocated to the DISC and its parent.[8] I.R.C. § 994(a).

[8] Many aspects of the statutory schemes are common to both the FSC and DISC provisions, for example, in the definition of "export property" and permissible pricing methods. For this reason, this brief follows the lead of the Ninth Circuit (App. at 6a n.3) and Boeing (Pet. at 3 n.2) in discussing only the DISC provisions of the Code. The FSC provisions differ from the DISC provisions in ways not pertinent to this case. App. at 6a n.3.

Boeing used the combined taxable income (CTI) method for calculating its intercompany revenues under section 994(a)(2) of the Code. App. at 3a, 7a. Under Treas. Reg. § 1.994-1(c)(7), the pricing of goods sold by a taxpayer to its DISC is made on a transaction-by-transaction basis. The taxpayer may elect, however, to determine the transfer price "on the basis of groups consisting of products or product lines." The taxpayer's choice of groupings "shall be controlling" and "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such groupings." Treas. Reg. § 1.994-1(c)(6)(iv). Costs (other than the cost of goods sold) [9]—

> which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions *definitely related, and therefore allocated and apportioned, thereto,* and (b) a ratable part of any other expenses, losses or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in section 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added). Several years later, the government issued a special allocation rule for R&D expenses. Treas. Reg. § 1.861-8(e)(3)[10] provides that R&D expenditures that a taxpayer deducts under section 174 of the Code shall ordinarily be considered deductions related to all income reasonably connected with product categories determined by reference to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget.[11]

[9] Treas. Reg. § 1.994-1(c)(6)(ii) provides that the cost of goods sold is calculated under Treas. Reg. § 61-3.

[10] App. at 43a. This regulation was later repromulgated as Treas. Reg. § 1.861-17.

[11] This requirement was amended in 1995 to encompass three-digit SIC Codes. Treas. Reg. § 1.861-17(a)(2(ii).

Under Treas. Reg. § 1.994-1(c)(7), Boeing grouped its export sales by program and apportioned costs, including R&D costs, to the particular airplane program for which those costs were incurred. All such specific product R&D costs were allocated to a specific program in the year in which they were incurred.[12] App. at 3a. R&D costs relating to basic research were apportioned to all airplane programs.[13] *Id.* Upon audit, the IRS—relying on Treas. Reg. § 1.861-8(e)(3)—reallocated R&D costs to all of Boeing Company's income from current commercial airplane sales in a single category under SIC Code 37 ("Transportation Equipment"), regardless of the relationship of the R&D expenses to the product being sold. App. at 18a. The IRS's method reduced Boeing's CTI for a current program within a given year by the R&D expenses incurred for a different program that same year. App. at 24a. The reallocation resulted in a tax deficiency of more than $400 million. App. at 15a.

The substantive issue in this case is the validity of Treas. Reg. § 1.861-8(e)(3) as used to calculate Boeing's CTI. In upholding Boeing's CTI calculation, the district court turned to the Eighth Circuit's decision in *St. Jude Medical,* which invalidated section 1.861-8(e)(3) as applied to the calculation of CTI. The district court found the Eighth Circuit's reasoning and analysis "persuasive and applicable to the current case." App. at 18a-19a. The court agreed with the Eighth Circuit that there were serious defects in applying Treas. Reg. § 1.861-8(e)(3) to the allocation of R&D expenses—defects that were "fatal" to the validity of the regulation. App. at 21a-23a.

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[12] Boeing referred to these R&D costs as "Company Sponsored Product Development," which were costs incurred for a specific program after the product was approved for development. App. at 3a.

[13] Boeing referred to these R&D costs as "Blue Sky R&D," which were costs incurred for basic research relating to commercial airplanes that might be the precursor to a specific program. App. at 2a-3a.

On appeal, the Ninth Circuit reversed, holding that Treas. Reg. § 1.861-8(e)(3) as applied to the CTI calculation is a permissible interpretation of the statute. App. at 6a. Concluding that the statute does not confine the relevant costs to be allocated to those definitely related to sales of a particular product, the court found that there is thus no conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(7). App. at 11a-12a. The Ninth Circuit's reasoning that Treas. Reg. § 1.861-8(e)(3) controls the calculation of CTI, however, is at odds with the DISC's statutory scheme and, upon careful review, cannot be sustained.

The DISC statute clearly requires a factual connection between income and expense. *See* I.R.C. § 994(a)(2) (requiring determination of net income "attributable to" the export sale). The legislative history of the provision confirms that "[t]hese rules generally allocate to each item of gross income all expenses *directly related thereto*, and then apportion other expenses among all items of gross income on a ratable basis." H.R. Rep. No. 92-533, at 74, *reprinted in* 1972-1 C.B. 498, 538 (emphasis added). CTI is determined by "deducting from the DISC's gross receipts cost of goods sold with respect to the property of both the DISC and the related person which are *directly related to the production or sale of the export property.*" *Id.* (emphasis added). Thus, expenses unrelated to property being exported are not allocated to export sales of the property.

As the Ninth Circuit acknowledged (at 7a), a taxpayer is permitted under Treas. Reg. § 1.994-1(c)(6)(iv) to choose the pricing method that maximizes its DISC's profits. In spite of the regulation's clear language that a taxpayer's groupings "shall be controlling," the court found that Boeing may not group its products along product lines but rather *was required* to use a broad two-digit SIC classification for allocating R&D expenses set forth in Treas. Reg. § 1.861-8(e)(3). As the Eighth Circuit determined in *St. Jude Medical*, however,

"[m]andating use of SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." 34 F.3d at 1401 (citations omitted). Moreover, the deemed relationship (between an expenditure for R&D and all income reasonably connected with a broad product category) mandated by the regulation is "inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related thereto.*'" *Id.* Finally, the SIC categories requiring gross income derived from successful R&D to bear the costs of the unsuccessful R&D are inconsistent with Congress's stated intent to deduct from the DISC's gross receipts only those costs that are directly related to the production or sale of the export property. *Id.*

In contrast to the challenged section 861 regulations, the section 994 regulations on intercompany pricing rules are consistent with congressional intent because they permit taxpayers to choose their product groupings. *Id.* Under section 994, expenses directly related to a particular product group (as defined by the taxpayer) cannot be allocated to the sales from a different product group. Thus, a DISC can maximize the amount of its deferred tax because its deductions from the gross income for a particular product line are limited to the expenses that directly relate to that product (and an apportioned portion of expenses not directly related to any product, such as overhead).[14] This clearly accords with the statute.[15]

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[14] *See St. Jude Medical*, 34 F.3d at 1402-03 ("Although a taxpayer may choose to allocate R&D expenditures to SIC categories consistent with Congress's intent when it promulgated the DISC intercompany pricing rules, mandating that the taxpayer do so is inconsistent with congressional intent. Doing so may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules.").

[15] That Boeing's R&D expenditures may have exceeded its income in a given product category in any year is irrelevant. The section 861 regulations clearly contemplate situations in which the costs directly related to a particular product line will exceed the gross income generated by that product line in a particular year. Treas. Reg. § 1.861-8(d)(1) specifically states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [dealing with the 'factual relationship between the deduction and a class of gross income'] even though, for the taxable year, *no gross income in such class is received.*" (Emphasis added.) The specific regulation relied upon by the government for the allocation of R&D expenses also provides that "[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping." Treas. Reg. § 1.861-8(e)(3)(ii)(B). This is consistent with the current deductibility of R&D expenses and the result of the annual accounting for taxes.

The Ninth Circuit's decision forces taxpayers in that circuit to allocate expenses that are directly related to a particular product—such as the Boeing 767—to income from unrelated products—such as the Boeing 747 which was designed years before—because both the 747 and the 767 are in the same broad two-digit SIC Code. There are significant differences even among products that may seem superficially similar. Even allocations within the slightly narrower three-digit SIC Codes now set forth in Treas. Reg. § 1.861-17 can lead to absurd results. For example, R&D expenses directly related to main frame computers would be allocated to pencil sharpener receipts because both pencil sharpeners and computers are in the same three-digit SIC Code (357—Computer and Office Equipment). Examples of other product groupings include canned tuna fish and freeze-dried coffee (SIC Code 209), perfumes and floor wax (SIC Code 284), and batteries and extension cords (SIC Code 369). Such ridiculous results cannot stand. The mandatory use of SIC Codes is an unreasonable interpretation of the DISC statute.[16]

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[16] In other areas, the government has recognized that the allocation of expenses according to SIC Codes may not always make sense. For example, for purposes of the possessions tax credit, the regulations provide that

IV.

As Justice Brandeis has noted, "it is more important that the applicable rule of law be settled than that it be settled right." *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). This case presents the opportunity for the Court to settle the issue and to get it right.

Because tax considerations play an important role in business decisions, "there is a special interest in the orderly, certain, and consistent interpretation of the Internal Revenue Code." *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 416 (1983) (Stevens, J. dissenting). That interest is not served by the Ninth Circuit's opinion. Moreover, the need for certainty and consistency is particularly acute where the statutes are intended to provide relief for taxpayers.

The Ninth Circuit's decision will undoubtedly increase the number of disputes between taxpayers and the Internal Revenue Service. This is undesirable because "[t]he taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are." *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973).

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marketing and distribution expenses shall generally be allocated according to a three-digit SIC Code, but the taxpayer may establish that the expenses are directly related to a specific class of income defined by specific product or group of product. *See* Treas. Reg. § 1.936-6(b)(1)(ii).

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari.

Respectfully submitted,

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